

FAIR VALUE CONCEPT SPECIFICS IN FINANCIAL REPORTING AND AUDITING

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Abstract: Investors have become the most important users of financial statements in modern business conditions, and mixed base of financial reporting has been established in order to meet their information needs and it includes elements of the concept of historical cost and the fair value concept, with an increasing shift towards the *fair value concept*. The primary task of fair value accounting becomes the expression of the fair value of the net assets at the reporting date, while the financial results represent the change in fair value of net assets between the two reporting periods. In our country the application of the "full IFRS" is mandatory for large enterprises and the application of IFRS for SMEs is mandatory for small and medium-sized entities, thus fair value accounting becomes an integral part of the financial statements of domestic companies. However, fair value accounting is not a suitable concept for our country characterized by shallow and underdeveloped financial market, companies whose owners are the company managers at the same time, and low level of economic and technological development. A financial statement audit in terms of the use of the fair value concept becomes much more demanding and complex than the audit of the financial statements based on historical cost accounting.

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1. Introduction

Operating business entities under conditions of growing resource limitations and tough competition results in a more dramatic increase in demand for

reliable information. The financial statements are one of the most important sources of information on business entities and their importance for users has been constantly increasing. Under modern business conditions, there has been a continuing increase in the number of users of financial statements and their demands. Protection of creditors' interests is no longer the primal objective, since investors are becoming the most important users of financial statements, and as the most powerful interest group, they have significant influence on the form and content of financial statements. In order to secure the interests of investors there has been a revision of the applicable rules for the recognition and evaluation of elements of financial statements. That resulted in the formation and implementation of mixed bases of financial reporting that contains the elements of the two concepts: the historical cost concept and the fair value concept, with a tendency to use the fair value concept more frequently.

According to some authors, mainly from the United States, we are in the midst of the greatest revolution in accounting and financial reporting since Luca Pacioli discovered a system of double-entry bookkeeping in 1494 (King, 2006, p. 12). Until recently, the accounting was based solely on the historical cost. Over the past thirty years, the Financial Accounting Standards Board (FASB) in the United States and the International Accounting Standards Board (IASB) have been moving away from historical cost and going towards the use of fair value accounting ("*Fair Value Accounting*"). Since 2009, the application of fair value accounting has become the standard method for all public and private companies in the United States (SFAS 157: *Fair Value Measurements*), and since 2011 it has become the standard method under IFRS 13: *Fair Value Measurement*. Up until the adoption of this standard, the requirements for fair value measurements were scattered through many of IAS / IFRS, and often they did not clearly express the method nor the purpose of fair value measurements, while guidelines on the application of the provisions of these standards were very limited. Therefore, the objectives of this paper are to assess the specificity of fair value accounting and to show the novelty brought by IFRS 13 which refers to the introduction of the "fair value hierarchy" in three levels, in order to increase the consistency and comparability of fair value measurement.

Also, one of the goals of this article is to point out the disadvantages of the fair value concept. Domestic and foreign professional literature defines two major disadvantages of the fair value concept - the procyclicality, which has its origin in the Income statement and in the overall result, and the illiquidity of capital market participants caused by assets or liabilities that are subject to valuation at fair value.

The specific objective of this paper is to give a critical review of both the fair value concept application in the financial reporting and the specifics of the audit of the fair-value financial statements in Serbia. Accounting regulations in Serbia prescribe the mandatory application of IAS / IFRS for years, so the application

of the fair value concept is part of the financial reporting in our country. The above-mentioned fact constantly sets new challenges to the accounting and auditing profession in Serbia. Accountants, in addition to the need for additional education and continuous professional development, are facing increasing pressures from owners and investors to use the methods of "creative accounting". Fair value measurement of assets and liabilities allows the possibility of accounting manipulation and fraud in the financial statements by the management.

Finally, at last but not least important objective of this paper is to discuss the challenges that auditors in our country face during the auditing of financial statements carried at fair value. The biggest challenge that auditors in our country face during auditing fair value measurements is the verification of the fair value measurement. The auditors have effective procedures to verify the transactions and balances that are valued at cost basis, but these methods are of little use in fair value measurement. The question is whether the auditors globally, and especially auditors in the Republic of Serbia, technically ready for the fair value challenges?

One of the ways to overcome the technical complexity of the fair value measurement, which requires the specialized knowledge in a particular area, is to hire an external specialists. However, in this case, the auditor should act in accordance with the guidelines of the ISA 620: *Using the Work of an Auditor's Expert* and use the results of experts in particular area. In the case where the auditor plans to use these results, that person should evaluate the professional competence of experts in order to be able to rely on their findings. In other words, the auditor remains responsible for his audit report on the validity of the assessment, and for this reason, it is inevitable that auditors acquire the knowledge and skills which appraisers have.

2. Characteristics of Fair Value Measurement and Disclosures in Accordance with IAS/IFRS

The fair value concept was developed in the Anglo-Saxon world. The Anglo-Saxon theory and practice endorses the view that the fair value represents true value and the most appropriate basis for financial reporting. Since the accounting system is determined by characteristics of the financial system, and that the Anglo-Saxon financial system is based on the capital market, the acceptance and application of the concept of fair value in the Anglo-Saxon practice have a consistent logic and full justification (Knežević, Pavlović, 2008, p. 8). Until recently, as opposed to the Anglo-Saxon accounting model, there was the Continental European model of accounting. The financial systems of continental Europe have been marked by the relative underdevelopment of capital markets for a long time, and funding was based mainly on bank loans. In

such systems that are characterized by a “close business relations between companies and banks, which are practically implemented through long-term, contractual relationship based business collaboration, the key financial transactors are banks, while the capital market is of secondary importance. The main creditors (banks) are often the most significant shareholders which are represented on the governing boards of companies. As a result, ownership is concentrated in the hands of a small number of large shareholders, and significant cross investments are common as well“ (Knežević, Pavlović, 2008, p. 9).

The Continental European accounting has always shied away from expressing unrealized profit, primarily due to unrealized gains distributions lethality. However, the globalization of financial markets, as well as the growing importance of capital markets and the growing dispersion of ownership in the countries of continental Europe, have led to a convergence of the financial system of the continental countries with the Anglo-Saxon financial system, which led to the harmonization of European directives with the Anglo-Saxon accounting model, through harmonization of directives with IAS/IFRS. Accordingly, the fair value concept has been recognized in the EU as well and the process of accepting the direct application of IAS/IFRS has started in both the EU and Serbia.

Several International Financial Reporting Standards define fair value as a required or permitted valuation process of assets and liabilities, but the main requirements have been crystallized in IFRS 13: *Fair Value Measurement*. This standard includes actions required to be undertaken during the measurement and disclosure of fair value, and defines that the ultimate goal of fair valuation is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (ie an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability).

In paragraph 9 of this Standard, the fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date“ (www.mfin.gov.rs).

The even more complete definition is given in paragraph 24 of the same standard, which states that fair value is “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (i.e. an exit price) regardless of whether that price is directly observable or estimated using another valuation technique“ (www.mfin.gov.rs).

Although the most common use of fair value is in valuation of financial instruments, IFRS is also allowing or even require the valuation at fair value of

many non-monetary assets, including property, plant and equipment, investment property, biological assets, assets held for sale (Chorafas, 2000, p. 241).

The application of fair value accounting has caused a change of form, content, and the number of financial statements, so that companies in the Republic of Serbia, which apply IFRS, are obliged to prepare the following financial statements: a balance sheet, an income statement, a statement of other comprehensive income, a statement of changes in equity, a cash flow statement and notes to the financial statements (Accounting Law, 2013). According to the revised IAS 1: *Presentation of Financial Statements*, it is required that the income statement or a separate report shows gains or losses resulting from changes in fair value of financial assets available for sale, the change in fair value of intangible assets, property, plant and equipment for which the subsequent measurement method through revaluation has been selected, actuarial gains and losses on defined benefit plans, as well as exchange differences arising from equity investments in entities abroad. In our country, it has been decided to express mentioned positions in a special report entitled *A statement of other comprehensive income*, and this report will be comprised for the first time within the financial statements for 2014.

In new circumstances, the result in the income statement shows the change in the fair value of net assets shown in the balance sheet as a result of the fact that, apart from realized results, the overall result of the reporting period includes gains and losses incurred on changes in fair value of assets and liabilities at a particular company at the reporting date. So, in fair value accounting "simply, the result is a change in fair value of assets and liabilities stated in the balance sheet" (Škarić-Jovanović, 2009, p. 422). This caused that "the balance sheet has a priority in the annual financial statements and the income statement plays a minor role" (Stojilković, 2011, p. 94).

The question is whether the fair value is a step forward? The introduction of fair value in accounting regulation is strongly supported by commercial banks, investment funds and other financial institutions, because it allows the expression of unrealized gains and losses, when the prices of their financial and other assets, which are stated at fair value, are growing. In this manner, it allows the management bonus payments and dividends right away, at the expense of future presumed inflows which will be achieved only if the market recognize the fair price of the assets which are already presented in the financial statements. In this manner the fair value concept causes unrealized gains which anticipate consumption and increase the price of shares and other securities in the financial markets, in the absence of inadequate risk assessment of certain financial instruments, which leads to investment in such instruments in order to make a quick profit, while their stock exchange share prices are rising. Unrealized gain that is distributed, due to the fact that absent-awaited new gains on fair value estimates may be paid only from external sources (debt) which leads to the

insolvency of such companies and the their subsequent share price fall on the stock market, which creates a loss for those who had shares in their portfolio.

“In relation to the question of whether the fair value is one of the causes of the financial crisis, the auditors from one of the leading audit firms in the world gave an interesting answer that accounting standards (GAAP and IFRS), did not cause the crisis, however, but they are certainly strengthened it.“ (Ćirović, 2008, str. 9). Probably influenced by the global financial crisis, at the end of 2008, the International Federation of Accountants - IFAC conducted a research on the impact of the fair value accounting on the financial crisis (IFAC, 2008, str. 30). The results of this study showed that the definition according to which the fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an independent transaction, is unclear and imprecise, considering the fact that it is assumed value which has not been confirmed on the market yet, ie. it is a present value that is expected to be realized in the future on the exercise date. The question is whether there is a future value that we can determine with certainty today? What happens if the market in the future recognizes only 50% of the income determined on the on a fair value basis, after taxes and dividends are paid out of profits?

In most cases, the fair value is the market value of the assets at the valuation date, but at some assets specific value is used as the fair value, which represents the present value of the cash flows that entity expects to realize with continuous usage of an asset and its disposal at the end of its useful life, or expected to be achieved during the settlement of obligations. For the fixed assets that are measured at the fair value "specific variables are only assumptions, and assumptions are usually predetermined by goals that are reflected in the quality of financial statements" (Ćirović, 2008, p. 9).

In domestic and a foreign professional community remains prevalent attitude about the advantages of the fair value in relation to historical cost when evaluating and expressing the value of fixed assets in the financial statements of business entities. This is most clearly seen in the attitude of a large number of certified auditors in our country, especially the auditors of the State Audit Institution, who refuse to express an unqualified opinion on the financial statements of the client, if an entity does not apply the fair value model in the fixed assets valuation, or if it has fixed assets in use, whose carrying value have been written off prematurely, i.e. equal to zero. This attitude seems to be valid because the financial statements do not show the real financial results and real financial position if fixed assets are stated at value less than market value. If the economic entity in its accounting policy defines that property, plant and equipment will be recognized at historical cost and will be depreciated faster in relation to their possible useful life, it will have higher depreciation costs in the short term. During this period, fixed assets will be recognized at the lower present value, and in the income statement, less profit will be recognized. In this case, the

balance sheet will contain latent reserves in the amount of higher depreciation, which represent the real financial resources of the enterprise. Since the recognition at historical cost represents one of the permitted methods of valuation in accordance with IAS 16 *Property, plant and equipment*, as well as an entity independently decide on the period of use and return on investment in the purchase of the assets, the historical cost concept and the need for a faster investment return through depreciation, meet the criteria of proper balancing and determination of the financial position of an entity that are contained in the relevant IAS.

If the economic entity opts for fixed assets recognition using the fair value model, then after the initial recognition of fixed assets at historical cost, entity measure their fair value, if that value can be measured reliably. The fair value of land and buildings is usually determined by the assessment performed by the professionally qualified valuers, based on market evidence. Revaluation should be conducted regularly to ensure that the carrying value does not differ significantly from the values determined by measuring the fair value at the balance sheet date. The revaluation model on fixed assets includes an increase in the present value of the underlying asset and revaluation reserve in equity and the calculation of higher tax depreciation in relation to the depreciation of the underlying asset for accounting purposes. At first glance, these effects give the impression that the revaluation method contributes to the preservation of physical capital in accordance with the the capital maintenance concept, because the amount of the revaluation increase the revaluation reserve and equity, and higher depreciation costs reduce profits for distribution, which leads to an increase in liquidity through reducing the net cash outflows.

However, the above conclusions about the advantages of using the fair value method in relation to the cost method are misleading because these effects disappear because depreciation is determined in a higher amount due to the application of fair value and it is not recognized as an expense in the tax balance (in our country), which means the amount of the tax liability which taxpayer is paying is the same, regardless of whether it performs revaluation of fixed assets or not.

On the other hand, the difference between the carrying value of the revalued asset and its tax base is treated as a temporary difference and it leads to deferred tax liabilities and deferred tax assets, in accordance with IAS 12 *Income Taxes*. Revaluation reserves can be successively transferred to retained earnings, in proportion to the increased amount of depreciation, so the retained earnings in the balance sheet will be the same as it was measured at historical cost. On prior, we can conclude that, when the tax balance does not recognize the effect of the depreciation increase due to the measurement of assets at fair value, which is the case with our tax regulations, then in the long run, these effects do not affect the amount of retained earnings and the company's financial position, which means they have a neutral effect on an entity.

When it comes to investment property, if an entity has chosen the revaluation model, then the changes in fair value of investment property are recorded in the income statement. In this way, during the period of real estate price growth, significant gains are realized. However, as these gains are not accompanied by corresponding cash flows and they represent taxable income, in the case of distribution of profits realized on that basis, there is a significant deterioration in the financial position. In the opposite case, when it comes to falling property prices, there are impairment losses which are not deductible for tax purposes, so the income tax is greater.

We can see that the International Accounting Standards Board is moving toward greater use of fair value when measuring elements of financial statements. However, in the application of fair value accounting, there are also some difficulties as well. The liquidity of capital markets around the world varies. Trade activities in certain markets and trade with some financial instruments may be so low that obtained market information is not sufficient. In gathering information on the fair value alternative sources of information could be simulations of hypothetical market or mathematical modeling. Reliability of such measurements is questionable. The differences in the reliability of market information and differences in the valuation methods would “likely lead to undesirable differences in evaluation and other assessments. In this way, the possibility of comparing the financial statements which have been prepared in accordance with International Financial Reporting Standards will reduce” (www.reuters.com/article). Efficient markets with low transaction costs are rare and the existence of market imperfections weak arguments used to support the relevance of the aforementioned evaluation. For those who apply valuation based on historical cost, recognizing estimated gains and losses that are based on market information can be a concept that is very complicated for understanding.

Considering the fact that the property, plant and equipment represent a significant assets in virtually all businesses, the impact of valuation of assets at fair value can probably best be seen in this group of assets. Arguments in favor of the assessment of fixed assets at fair value are:

1. *Improving the financial status and position of the entity* – that occurs if the effects of estimates in the financial statements are positive, which results in an increase in the assets and liabilities of the balance sheet because it increases the value of property, plant and equipment, and it also results in an increase of the revaluation reserve, and therefore the total shareholders' equity.
2. *Decreasing the debt ratio of the entity* – if the effect of the measurement is positive, there is a recognition of revaluation reserves, i.e. there is an increase of total shareholders' equity. This means that debt-to-capital ratio is lower, thus reducing the debt ratio of the entity, and a company is using less leverage and has a stronger equity position.

3. *The possibility of using the realized revaluation reserves and reduction of taxable income when selling the fixed asset.*

The reasons which do not favor the valuation of property, plant and equipment at fair value are:

1. *The higher depreciation cost and less profit in the income statement* - in following reporting periods due to the increased value of property, plant and equipment, and the basis for depreciation and depreciation cost are higher and net profit in the income statement is lower. This results in a lower financial result;
2. *Fair value measurement of assets does not affect the cash flows and not improving the liquidity and solvency of the entity*, since there are no cash inflows and outflows, i.e. the measurement at fair value of property, plant and equipment has no effect on the cash flow statement.
3. *Inability to use the unrealized revaluation reserve* - revaluation reserves cannot be used before the disposal of fixed assets. Therefore, only when "the asset is sold, disposed, gifts, exchange or otherwise disposed of, the related amount of the revaluation reserve may be transferred to retained earnings" (Negovanović, 2007, p. 186). Only in exceptional cases, a portion of the revaluation reserve may be transferred to retained earnings and that part which represents the depreciation calculated on the revalued assets and depreciation based on the asset's value.
4. *Fair value measurement of fixed assets cannot increase the amount of tax depreciation and thus pay less income tax*. Fair value measurement of investment properties increases the value of total assets and revenues.
5. *Subsequently, fair value measurement is in conflict with at least two accounting principles, the precautionary principle and the principle of realization*, because the precautionary principle requires that the assets in the balance sheet stated at the lower value and liabilities at a higher value, and in the case of the fair value measurement, assets are recognized at a higher, rather than lower values (Savić, 2014, p. 35). When it comes to principle of realization, while increasing the value of investment property which has resulted in an increase in revenue shall be premature recognition of gains which have not yet been validated in the market. In such cases, the measurement at fair value is not in accordance with the principle of realization.
6. *The measurement at fair value of property, plant and equipment may lead to the application of a mixture of different values in the financial statements*, because it may happen that several positions in the financial statements are recognized at different values, so the usefulness of the financial statements significantly decreases.
7. *In our country there is no title of professional valuer and there is no mandatory application of the International Valuation Standards*, which calls into question the objectivity of the fair value measurement.

In October of 2007, there was a research entitled “EU Implementation of IFRS and the Fair Value Directive - Report for the European Commission” whose subject was the application of IFRS in the financial statements of companies from European Union member countries (www.icaew.com/ecifrsstudy). Since 2005, within the EU, the companies whose securities are traded on the stock exchange have the obligation to prepare financial statements in accordance with IFRS. Two hundred largest companies in the EU member states whose securities are traded on the stock exchange and applying IFRS, participated in the part of the research regarding financial reporting at fair value. The research results have astonished many experts. The results are as follows: 200 surveyed companies, 191 companies applied cost model for the valuation of property, plant and equipment (95.5%), eight companies (4%) applied the revaluation model, i.e. the valuation at fair value, while one company does not own property, plant and equipment (which is 0.5%). When it comes to investment property, 119 companies (59.5%) do not own investment property, 58 applied cost model (29%), while only 23 companies valued investment property at fair value (which is exactly 11.5%) (www.icaew.com/ecifrsstudy). It is interesting that the valuation of plant and equipment at fair value does not exist.

These results clearly indicate that the cost method is still dominant in relation to the fair value model. Based on all the above, it can be concluded that the subsequent measurement of property, plant and equipment under the historical cost still has a great advantage in practice compared to the fair value valuation, despite the recommendations of IFRS and a certain part of the global professional accountancy public. If you follow the principle of historical cost, assets acquired through purchase on the market are valued at historical cost, and assets which are the results of the manufacturing process are valued at the amount of costs which were necessary for its production. However, the market value of the property does not have and in many cases is not equal to the value that is in the balance sheet, which leads to the reduction of propositional power of accounting data, and thus comes with a reduction in the quality of financial reporting. Despite previous facts, the principle of historical cost is not abandoned, but on the contrary, and the reason is primarily in the objectivity of this data, because the cost value and the cost price are real values which are supported by appropriate documentation.

3. The Effects of *IFRS 13: Fair Value Measurement* on Financial Reporting in the Republic of Serbia

IFRS 13: Fair Value Measurement, will be implemented in Serbia, starting from the financial statements for 2014, because the translation of this standard was published in March 2014 on the website of the Ministry of Finance of the Republic of Serbia.

Fair value measurement should be understood as “a process that runs over the complex facts in order to arrive at numbers that represent values“ (Milojević, 2014, p. 7). The fair value is one of the basic concepts of International Financial Reporting Standards, which occurs in numerous standards.

The main objective of IFRS 13 is specifying the manner of fair value measurement. In fact, until the adoption of IFRS 13, a single set of rules for the measurement of fair value has not been defined, but each standard prescribed its own rules, which in some cases were inconsistent. IFRS 13 does not make substantive changes in the fair value measurement, however, this standard basically explains the process of fair value measurement and provides general rules, in considerably more detail than is currently the case. In addition to these refinements, IFRS 13 introduces some new concepts, e.g. previously it was defined that the fair value is determined on the market, and now the concept of the market is explained in details and introduced the concepts of the principal market and the most the transaction and their characteristics are precisely defined.

IFRS 13 is used in cases when some IFRSs require or permit entities to measure or disclose the fair value of assets or liabilities. One of the key requirements of IFRS 13 is that, unless another IFRS requires or permits an entity initial measurement of the asset or liability at fair value and the transaction price differs from fair value, an entity should recognize the resulting gain or loss in the balance sheet unless otherwise is indicated in that IFRS.

This standard states that a fair value measurement requires an entity to determine the following:

- the particular asset or liability being measured
- the highest and best use of the asset (for a non-financial asset)
- the principal market for the asset or liability or in the absence of a principal market, the most advantageous market for the asset or liability
- the appropriate valuation technique(s) to use when measuring fair value.

A fair value measurement is used for a particular asset or liability, therefore, when measuring fair value an entity shall take into account the characteristics of the asset or liability at the measurement date, and such characteristics include, for example, the condition and location of the asset and restrictions, if any, on the sale or use of the asset. The asset or liability measured at fair value might be either a stand-alone asset or liability or a group of assets and liabilities (e.g. a cash-generating unit).

An entry price – the transaction price is the price that needs to be paid in order to acquire the asset or received to assume the liability in cases when an asset is acquired or a liability is assumed in an exchange transaction for that

liability or asset. In contrast, the fair value of the asset or liability is the price that would be received to sell the asset or paid to transfer the liability - an exit price. In most cases the transaction price will equal the fair value, e.g. that might be the case when on the transaction date the transaction to buy an asset takes place in the market in which the asset would be sold. A fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either in the principal market for the asset or liability or in the absence of a principal market, in the most advantageous market for the asset or liability. The market in which the entity would normally enter into a transaction to sell the asset or to transfer the liability is presumed to be the principal market or, in the absence of a principal market, the most advantageous market (which will bring the highest income and lowest costs), in the absence of evidence to the contrary. If there is a principal market for the asset or liability, the fair value measurement shall represent the price in that market whether that price is directly observable or estimated using another valuation technique, even if the price in a different market is potentially more advantageous at the measurement date.

An entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest.

The price in the market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs, because transaction costs are not a characteristic of an asset or a liability, but rather, they are specific to particular transactions and will differ depending on how an entity enters into a transaction for the asset or liability. But, if location is a characteristic of the asset, the price in the principal or most advantageous market shall be adjusted for the costs that would be incurred to transport the asset from its current location to that market.

When it comes to a fair value measurement of a non-financial asset, what should be taken into account is a market participant's ability to achieve economic benefits by using the asset in its best and highest use or by selling it to another market participant that would use this asset in its highest and best use. The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, and it is determined from the perspective of market participants, even if the entity intends a different use. However, an entity's current use of a non-financial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset.

IFRS 13 specifies that an entity should use valuation techniques that are appropriate to the circumstances and for which sufficient data are available to measure the fair value, maximising the use of relevant observable inputs and

minimising the use of unobservable inputs. The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. The three most commonly used valuation techniques are the following (www.mfin.gov.rs):

1. The market approach (uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business).
2. The cost approach (reflects the amount that would be required currently to replace the service capacity of an asset).
3. The income approach (converts future amounts to a single current (i.e. discounted) amount. In this case the fair value measurement reflects current market expectations about those future amounts).

In some cases such as e.g. when valuing an asset or a liability using quoted prices in an active market for identical assets or liabilities, a single valuation technique would be appropriate. In other cases, multiple valuation techniques would be appropriate, and typical example might be the case when valuing a cash-generating unit. If multiple valuation techniques are used to measure fair value, the results should be evaluated considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances. Valuation techniques used to measure fair value shall be applied consistently. However, a change in a valuation technique or its application (e.g. a change in its weighting when multiple valuation techniques are used or a change in an adjustment applied to a valuation technique) is appropriate if it results in a measurement that is equally or more representative of fair value under the given circumstances, for instance: new markets develop, new information becomes available, when information previously used is no longer available, in case of valuation techniques improvement or when market conditions are changed. Revisions resulting from a change in the valuation technique or its application should be accounted as a change in accounting estimate in accordance with IAS 8.

This standard establishes a fair value hierarchy that categorises the inputs to valuation techniques used to measure fair value into three levels. This hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs).

Level 1 inputs in our country can be considered quoted prices for stocks and bonds and the listing of the Belgrade Stock Exchange "prime market", quoted prices of agricultural products with the Commodity Exchange in Novi Sad, publicly available real estate prices, catalog assessment of motor vehicles by the Automobile and Motorcycle Association of Serbia (AMSS) (Negovanović, 2014, p. 182).

Sometimes, the inputs used in order to measure the fair value of an asset or a liability can be categorised within different fair value hierarchy levels. In those cases, the fair value measurement is categorised in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement. Assessing the significance of a particular input to the entire measurement requires judgement. The availability of relevant inputs and their relative subjectivity might affect the selection of appropriate valuation techniques. However, the fair value hierarchy does not prioritise the valuation techniques used to measure fair value, but prioritises the inputs to valuation techniques instead.

If an observable input requires an adjustment using an unobservable input and that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would be categorised within Level 3 of the fair value hierarchy. For instance, if a market participant would take into account the effect of a restriction on the sale of an asset when estimating the price for the asset, an entity would adjust the quoted price to reflect the effect of that restriction. If that quoted price is a Level 2 input and the adjustment is an unobservable input that is significant to the entire measurement, the measurement would be categorised within Level 3 of the fair value hierarchy.

Level 2 inputs are, apart from being quoted prices included within Level 1, inputs that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include the quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, market-corroborated inputs. An example of Level 2 inputs in our country would be the market price of the company's shares that are traded on a multilateral trading platform (MTP).

Level 3 inputs are unobservable inputs for the asset or liability that should be used to measure fair value in cases when relevant observable inputs are not available. However, the fair value measurement objective remains the same, and that is an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability. For this reason, unobservable inputs should reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. Assumptions about risk include the risk inherent in a particular valuation technique used to measure fair value and the risk inherent in the inputs to the valuation technique. This standard establishes that an entity should develop unobservable inputs using the best information available in the circumstances, which might include the entity's own data. As an example, the input of the third level in our conditions can be specified estimate the fair value of shares for which there is no active market, quoted or published prices for similar entities that have been the subject of sale, and use of the yield method based on the present value of future cash flows projected leadership the only logical choice.

What might be specified as an example of Level 3 inputs in our conditions is the fair value measurement of shares for which there is no active market, nor quoted or published prices for similar entities that have been the subject of sale, and use of the income approach based on the present value of future cash flows projected by management is the only logical choice.

When it comes to disclosure of information related to assets and liabilities that are measured at fair value, IFRS 13 prescribes in detail all the information that an entity should disclose in the notes to the financial statements, for each class of assets and liabilities measured at fair value. An entity should present the quantitative disclosures required by this IFRS in a tabular format unless another format is more appropriate (Petrović, 2013, p. 25).

4. The Specifics of the Financial Statement Audit in terms of Applying the Fair Value Concept in the Republic of Serbia

“Due to the fact that the information in the financial statements are precondition for the activities on the financial markets, it is necessary to be audited by an independent audit in order to prevent the wrong signals to investors and mitigate the negative effects of the “creative“ balance sheet information. Thus, it is important role of auditing“ (Stojilković, Bonić, 2009, p. 146).

The legal framework within which auditors operate in the Republic of Serbia is the Law on Auditing which refers to the professional regulations - the International Standards on Auditing (ISA - International Standards on Auditing). In particular, auditing procedures applied during the auditing of accounting estimates and fair value estimates, directly establishes the International Standards on Auditing 540 *Auditing accounting estimates, including fair value accounting estimates, and related disclosures*.

Generally speaking, auditing fair value accounting estimates represents the “logical continuation of the procedure normally used for other types of auditing accounting estimates such as provision of warranty repair or allowance for doubtful accounts“ (Kumarasiri, Fisher, 2011, p. 69).

This standard has been implemented before IFRS 13: *Fair Value Measurement* was adopted, and applies to accounting estimates. Some financial statement items cannot be measured precisely, but can only be estimated. Accounting estimate represents “an approximation of a monetary amount in the absence of a precise means of measurement” (SRRS, 2011, p. 34). Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. The use of reasonable estimates is an essential part of the preparation of financial statements and does not threaten their reliability. An assessment involves judgments based on the latest available, reliable

information. Management is responsible for the reasonableness of accounting estimates and appropriateness of accounting policies.

The objective of a fair value measurement is to estimate “the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability)” (www.mfin.gov.rs). According to ISA 540, the objective of the auditor is to obtain sufficient, appropriate audit evidence about whether accounting estimates, including fair value accounting estimates, in the financial statements, are reasonable, and related disclosures in the financial statements are adequate (SRRS, 2011, p. 456).

ISA 540 consists the following segments:

1. risk assessment procedures and related activities
2. identifying and assessing the risks of material misstatement
3. responses to the assessed risks of material misstatement
4. further substantive procedures to respond to significant risks
5. evaluating the reasonableness of the accounting estimates, and determining misstatements
6. disclosures related to accounting estimates
7. indicators of possible management bias
8. written representations
9. documentation (SRRS, 2011, p. 453).

For some accounting estimates there may be relatively high estimation uncertainty, particularly when they are based on significant assumptions, for example: fair value accounting estimates for derivative financial instruments not publicly traded, fair value accounting estimates for which a highly specialized entity developed model is used or for which there are assumptions that cannot be observed in the marketplace.

1. Risk Assessment Procedures and Related Activities

In order to identify and assess the risks of material misstatement and in order to plan the nature, timing and extent of audit procedures, it is necessary, above all, that an auditor understands activity controls which management has established during the fair value measurement. When performing risk assessment procedures to obtain an understanding of the entity and its environment, including the entity’s internal control, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

- the requirements of the applicable financial reporting framework relevant to fair value accounting estimates, including related disclosures;

- how management identifies those transactions, events and conditions important for recognition, measurement and disclosure of fair value in the financial statements;
- how management identifies methods and models used in making fair value accounting estimates, and relevant controls, whether management has used an expert, the assumptions underlying the fair value accounting estimates, whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why, whether and, if so, how management has assessed the effect of estimation uncertainty (SRRS, 2011, p. 457).

In certain cases, financial reporting framework prescribes specific method of measurement (for example, special valuation model for fair value estimates). However, in most cases, the financial reporting framework does not prescribe the method of measurement and it does not specify alternative measurement methods. The risk of material misstatement is greater in cases when entity developed model for fair value accounting estimates is used by the management, or in cases when used model differs from the method that is commonly used in a particular activity or environment.

Matters that the auditor may consider in obtaining an understanding of relevant controls include, for example, the experience and competence of those who make the accounting estimates, and controls related to:

- how management determines the completeness, relevance and accuracy of the data used to develop accounting estimates;
- the review and approval of accounting estimates, including the assumptions used in their development, by appropriate levels of management;
- the segregation of duties between those committing the entity to the underlying transactions and those responsible for making the accounting estimates (SRRS, 2011, p. 468).

2. Identifying and Assessing the Risks of Material Misstatement

The auditor should assess the degree of uncertainty of fair value estimates. As an example of accounting estimates with high estimation uncertainty there is a fair value accounting estimate for which a highly specialized entity developed model is used.

3. Responses to the Assessed Risks of Material Misstatement

Based on the assessed risks of material misstatement, the auditor shall determine whether management has applied the requirements of the applicable financial reporting framework relevant to the fair value accounting estimates and whether the methods for making the fair value accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period

are appropriate in the circumstances (for example, the emergence of an active market for a particular class of asset or liability may indicate that the use of discounted cash flow is no longer suitable method of estimating the fair value of the observed classes of assets or liabilities). The auditor should consider whether specialized skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence.

When it comes to complex assessment procedure that requires a specialized knowledge in a particular area, the auditor should act in accordance with the guidelines of the *ISA 620 Using the Work of an Auditor's Expert*, i.e. to use the results of experts for a particular area. When planning to use the results of an auditor's expert, the auditor should evaluate the professional competence of that expert, which is reflected in possession of a professional certificate, license or membership of an appropriate professional organization, as well as the experience and reputation in the area in which the auditor seeks audit evidence. Also, it is necessary for auditor to assess the objectivity of the auditor's expert in order to rely on its findings.

4. Further Substantive Procedures to Respond to Significant Risks

The auditor special attention should be directed to the estimation uncertainty and criteria of its measurement and recognition.

5. Evaluating the Reasonableness of the Accounting Estimates and Determining Misstatements

The auditor should assess, on the basis of audit evidence, whether the fair value accounting estimates in the financial statements are reasonable in relation to the appropriate financial reporting framework or they are wrong. "The greater participation of fair value accounting estimates, obtained by different techniques in fair value accounting of certain enterprise, the lower reliability of the information presented, due to the wide possibilities of manipulation" (Škarić-Jovanović, 2009, p. 424).

6. Disclosures Related to Accounting Estimates

The auditor shall obtain sufficient appropriate audit evidence on whether the disclosures in the financial statements related to fair value accounting estimates are in accordance with the requirements of the applicable financial reporting framework. Disclosure of fair value is defined in IFRS 13 *Fair Value Measurement*, whereby the entity should disclose the valuation techniques and inputs used to develop those fair value measurements and it should show the effect of the measurements on profit or loss or other comprehensive income for the period for assets and liabilities for which significant unobservable inputs (Level 3) are used.

7. Indicators of Possible Management Bias

Some examples of the indicators of possible management bias with respect to accounting are: changes in an accounting estimate, or the method for making it, in cases when management has made a subjective assessment that there has been a change in circumstances, use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions, selection of a point estimate that may indicate a pattern of optimistic or pessimistic model, etc.

8. Written Representations of Management

The auditor should obtain written representations from management whether they believe significant assumptions used in making accounting estimates are reasonable or not.

9. Documentation

The auditor shall include in the audit documentation the basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks, and indicators of possible management bias, if any (SRRS, 2011, p. 461).

In studies conducted in other developing countries whose objective was to identify and examine the issues and challenges that the auditors in developing countries face, revealed the following conclusions. In most cases, auditors support the fair value concept in financial reporting, but determined that there are certain accounting and auditing matters related to the implementation of this concept.

The economies of developing countries, including Serbia, are characterized by limited availability of practitioners (real estate appraisers, actuaries and other specialists), who have the necessary skills and experience to apply the appropriate assessment techniques of fair value measurement and the International Valuation Standards, undeveloped and inactive financial markets, and situation in which the expense associated with the implementation of fair value accounting estimates and their disclosure often exceed the benefits of information obtained (Kumarasiri, Fisher, 2011, p. 68). As a result of the study it has been cited that the auditors consider that fair value accounting represents a much bigger challenge to perform audits in relation to accounting based on historical cost. The auditors who participated in the survey, as the main problems cited lack of auditor knowledge due to fair value accounting estimates, the prevalence of inactive markets for assets and liabilities that are subject to fair valuation measurement, difficulties associated with the variation in techniques used to ascertain fair values across different industries, and the incorporation of future events and conditions into valuations (Kumarasiri, Fisher, 2011, p. 82).

In our country, an audit professional body - Chamber of Authorized Auditors, should take an important role, which should identify the main problems auditors encountered during the audit in terms of the application of fair value accounting, and should provide more professional training for auditors in the fair value measurement of assets and liabilities.

5. Conclusion

The financial reporting on capital market should primarily provide the fulfillment of the investors' needs for information in order to make investment decisions with the aim to maximize profits. "Achieving high rates of profits from quarter to quarter is set as an imperative for managements of modern corporations, not only in the USA but also in the world" (Stojilković, 2010, p. 170).

In relation to the European accounting doctrine that insists on the principle of historical cost and only the recognition of gains that have been realized in the market, IFRS provides a greater possibility of applying the fair value accounting. In the last few years, in professional circles, there is a debate about fair value accounting which becomes the subject of growing criticism and objections. Although the greater objectivity of financial statements that show better information in the financial statements has been set forth as the main reason for introducing the fair value concept in accounting theory and practice, experience indicates that the application of fair value creates space for financial statement manipulation and the so-called "creative accounting". Nevertheless, modern accounting theory and practice is characterized by the increasing use of fair value accounting, which involves increasing subjectivity in the evaluation of assets and liabilities. However, too much subjectivity can cause the opposite effect.

The application of fair value accounting in our country has caused a change of form, content, and the number of financial statements, and the novelty is a statement of other comprehensive income which contains items of income and expense that are not recognized in the income statement but recognized in equity instead.

Up to the 2013, individual IFRS were dealing with the fair value measurement, and they predicted mandatory or permitted valuation at fair value. To reduce the negative effects, the creators of accounting standards adopted new IFRS 13 Fair Value Measurement, which provides guidance on determining the fair value of assets and liabilities and defines guidelines regarding disclosure of necessary information, all in order to provide a more realistic financial reporting .

The application of the fair value concept greatly contributed to the creation of increased financial results, artificially increased profits and dividends in the financial statements of business entities that have applied this method incorrectly

or this was a result of the inherent limitations in applying these methods in different market conditions (boom of markets or crisis on the market).

This resulted in a very complex and challenging situation for auditors, as it is expected that in the new circumstances, they adequately express an audit opinion. Auditing accounting estimates, including fair value accounting estimates, is characterized by the existence of high inherent risk because the fair value measurement occurs as a result of judgment. More frequent use of fair value assessment techniques ("mark-to-model") requires that auditors have knowledge in these areas. Using the work of an auditor's experts for a particular area can be seen as one way to overcome the problem of technically complex estimates verification. However, this does not in any way absolve auditor of his responsibility for evaluating validity of the assessment, and additional training for auditors is inevitable. The auditor's professional body - Chamber of Authorized Auditors, should have more initiative and it should identify the problems that auditors are facing and it should respond in a timely manner.

Based on the above it can be concluded that the financial statement audit in the circumstances characterized by increasing use of fair value accounting, is considerably more demanding and complex in relation to the audit of the financial statements based on historical cost accounting.

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SPECIFIČNOSTI KONCEPTA FER VREDNOVANJA U FINANSIJSKOM IZVEŠTAVANJU I REVIZIJI

Apstrakt: U savremenim uslovima poslovanja investitori postaju najvažniji korisnik finansijskih izveštaja, a u cilju zadovoljenja njihovih informacionih potreba dolazi do formiranja mešovite osnove finansijskog izveštavanja koja sadrži elemente koncepta istorijskog troška i koncepta fer vrednosti, sa sve većim zaokretom ka konceptu fer vrednosti. Primarni zadatak računovodstva fer vrednosti postaje iskazivanje fer vrednosti neto imovine na dan izveštavanja, pri čemu finansijski rezultat poslovanja predstavlja promenu fer vrednosti neto imovine između dva izveštajna perioda. U našoj zemlji propisana je obavezna primena “punih“ MSFI za velika, odnosno MSFI za mala i srednja pravna lica, čime računovodstvo fer vrednosti postaje sastavni deo finansijskih izveštaja domaćih poslovnih subjekata. Ipak, računovodstvo fer vrednosti nije primeren koncept za našu zemlju koju odlikuju plitko i nerazvijeno finansijsko tržište, privredna društva čiji su vlasnici u najvećem broju slučajeva istovremeno i upravljači, i nizak stepen ekonomskog i tehničko-tehnološkog razvoja. Revizija finansijskih izveštaja u uslovima upotrebe koncepta fer vrednosti postaje znatno zahtevnija i složenija u odnosu na reviziju finansijskih izveštaja zasnovanih na računovodstvu istorijskog troška.

Ključne reči: koncept fer vrednosti, MRS/MSFI, MSFI 13: Odmeravanje fer vrednosti, revizija finansijskih izveštaja